COMMENTARY

JULY—SEPTEMBER 1961

The measures adopted at the end of July and described in the previous issue of this Bulletin were intended to relieve pressure on sterling and to give early benefit to the balance of payments. They were designed to be consistent with, and to provide time for, the adoption of longer-term policies, which would help to prevent the periodic recurrence of external deficits and to ensure the continuance and, if possible, the acceleration of economic growth without impairing external solvency.

By the end of October it could be claimed that the short-term aims of the July measures had largely been achieved.

Effects of the July measures on sterling and the money market

During the first three weeks of July, notwithstanding substantial official support, the rate of exchange for sterling against the U.S. dollar had fluctuated around $2·78½. In October, despite large purchases of dollars in the market by the authorities, the rate touched $2·81¾. Between the end of July and the end of October the reserves rose by £385 million only part of which could be attributed to special factors. These special factors were the drawing of £536 million from the International Monetary Fund, the receipt of £27 million from an advance repayment of debt by France, the repayment of the bulk of the money borrowed earlier under the Basle arrangements and finally the repayment of £100 million to the I.M.F. at the end of October.

Reported movements in the sterling holdings of non-official holders outside the sterling area, foreign exchange rates, and short-term interest rates, all tend to confirm market reports that the strength of sterling in August and September was primarily due to the reversal of short positions[a] and that a return of investment funds, either covered or uncovered, only began on any scale in October.

Outside the sterling area, reported holdings of sterling on non-official account appear to have been practically unchanged in August and September apart from the fall due to the repayment of Basle support.[b] It does not seem likely that, apart from some switching of foreign currency deposits, a large inflow was being invested in those assets which are not included in the statistics of overseas sterling holdings. The figures therefore suggest that no large investment inflow took place during August and September. In October, by contrast, non-official holdings of sterling outside the sterling area seem to have risen quite sharply, suggesting some investment inflow.

Movements in the rate for security sterling in New York also support the presumption that an investment inflow did not take place on any scale until October. This rate rose during August from $2·77¾ to $2·79$\frac{9}{16}$, but proportionately little more than the rate for external sterling, so that over the month the discount for security sterling against external sterling fell only slightly from $\frac{11}{16}$% to ⅜%. In September the rate was little changed but in October it rose sharply to reach $2·81½ at which level its discount on external sterling was only $\frac{1}{16}$%, a negligible margin in this market, and consistent with an overall net investment inflow. The " Balancing item " in the balance of payments

---

[a] In the present Commentary the term " short positions " is used to cover abnormally low working balances held in sterling (including inter-company accounts); unusually large commercial borrowing from the United Kingdom; and delays in making commercial payments due to the United Kingdom and acceleration of payments due from the United Kingdom (leads and lags). This definition allows a distinction to be drawn between the " reversal of short positions " and other movements of funds to the United Kingdom for investment primarily in short-term assets such as Treasury Bills and loans to local authorities.

[b] See pages 5 and 14.

statistics for the third quarter was positive and was large; this was consistent with the reversal during August and September of the leads and lags position previously built up.

The course of interest and forward exchange rates over August and September meant that during these two months covered short-term investment in the United Kingdom showed only a small net advantage on the Treasury Bill comparison. After the increase in Bank Rate on the 25th July a small premium in favour of covered investment in London emerged on this comparison for the first time for over two months. It fluctuated around $\frac{1}{4}$% per annum until October when the three months' Treasury Bill rate in London began to fall rapidly. The fall was, however, more than offset by an accompanying reduction in the discount on forward sterling, so that the premium in favour of London rose and at the end of October stood at $\frac{11}{16}$% per annum;[a] a level which could be expected to lead to covered investment.

These movements in interest and forward exchange rates had already, immediately after July, made it profitable for banks in London to hold (covered forward) a larger quantity of sterling short-term assets, particularly loans to local authorities[a] and deposits with hire purchase finance companies, against their foreign currency liabilities. Although interest rate considerations are not the only motive for changes in the composition of the assets held against these liabilities, it is significant that during August and September such sterling assets rose by some £30 million and in October by some £20 million. These operations probably played a significant part in the demand for sterling throughout these three months.

Short-term rates in the local authority market rose sharply after the 25th July. Before then some overseas funds had been withdrawn from this market and though the switching of foreign currency deposits into sterling after the 25th July provided some funds, the local authorities then became subject to pressures for the repayment of bank advances. As a result the rate for seven days' money in this market fluctuated between $7\frac{1}{8}$% and $7\frac{5}{8}$% during August and September. In October it fell in response to the reduction in Bank Rate on the 5th October, to a larger inflow of overseas money, and also to expectations of a further fall in interest rates and a further inflow of overseas money. At the end of October it was around $6\frac{5}{8}$%.

Hire purchase finance companies had also been affected by some outflow of overseas funds between March and July; subsequently they too were pressed to reduce their bank advances. Members of the Finance Houses Association and the Industrial Bankers' Association had been asked in July not to increase deposits in order to finance an expansion of business beyond their existing commitments. Outstanding hire purchase debt owed to finance houses fell during August and September, but the need to repay bank advances obliged finance companies to increase their borrowing on deposits. Some companies were offering 8% for three months' deposits in August and September.

Whether there is any advantage to be gained from a covered investment in U.K. short-term assets or from the switching of foreign currency deposits, covered forward, into sterling for investment with U.K. local authorities and hire purchase finance companies will partly depend upon the prevailing discount or premium on forward sterling. No such consideration applies to uncovered investment. Yet despite yields on U.S. and U.K. three months' Treasury Bills showing during August and September a gross margin in favour of London of over 4%, the evidence suggests that the total investment inflow during these months was small. Reports suggest that some part of the investment inflow in October was probably uncovered.

It may seem incongruous that the restoration of confidence in sterling immediately following the July measures was enough to persuade traders to reverse short positions but did not lead, until October, to any return of uncovered investment funds. It may be, however, that once fears of an imminent change in the exchange parity of sterling had disappeared, trading companies found it convenient and perhaps cheaper to revert to their normal practices in the timing of their receipts and disbursements, whereas a more positive inducement and a

[a] See graph on page 72.

longer passage of time were required before uncovered funds returned to London. In 1951-52 and 1957-58 the Government's measures halted the immediate drain on the reserves, but on both occasions (though less noticeably in 1957-58) there was a short interval before an investment inflow of funds was attracted; this may, to some extent, be due to such funds having been invested for a given term in other financial centres in a form that was not quickly realisable. It may also be that the reduction in Bank Rate from 7% to 6½% on the 5th October drew attention to the possibility that high short-term rates in the United Kingdom would not persist for so long as might have been expected. This in turn may have encouraged some immediate inflow of funds in search of short-term capital appreciation.

I.M.F. meeting

Concern lest the International Monetary Fund might have insufficient resources to meet the demands that might be made upon it formed the background to the Annual Meeting of the I.M.F. in Vienna during the second half of September. The main subject discussed was the possibility of reinforcing the I.M.F.'s resources through an agreement whereby the I.M.F. could borrow as appropriate from the main industrial countries. Members generally accepted that such an agreement was desirable if the I.M.F. were to provide adequate help in meeting severe strains on the international exchange system. Some representatives, especially those from countries which would, under the proposed agreement, now be lenders to the I.M.F., made it clear that in their view an increase in international credit, however necessary in certain circumstances, should not be regarded as an alternative to satisfactory domestic policies. Much emphasis was laid on the need to ensure that any additional resources should only be used to avert a threat to exchange stability and then only under the conditions applied by the I.M.F. in the past. There was a broad measure of agreement that a scheme, incorporating satisfactory safeguards for the lenders, should be worked out in the ensuing months. The fact that no specific agreement was concluded at Vienna left a question mark over the international exchange system and may have been an additional factor behind an inflow of uncovered funds to London in October.

Gold market

The international political situation and concern for the future of the exchange and payments system led to increased buying of gold during the third quarter and supplies from new production were frequently insufficient to meet demand. At the same time less was being offered from other sources than earlier in the year; in particular there was, after the 25th July, no need for the Bank of England, on behalf of the Exchange Equalisation Account, to sell gold to replenish the Account's holdings of convertible currencies. Turnover in the market was substantial and the price rose from \$35·08¼ per fine ounce on the 30th June to \$35·19½ per fine ounce at the end of October. Since the end of July the Bank have sold moderate amounts of gold in the market to prevent the price rising to the point at which gold purchased in the United States could be sold at a profit after shipment across the Atlantic.

The Basle arrangements

Further repayments of the assistance provided under the Basle arrangements were made.[a] Some £295 million was repaid during the third calendar quarter, £200 million in August. At the end of September some £27½ million was outstanding. During October a further £10 million was repaid and an agreement was signed providing for a loan of 215 million Swiss francs (equivalent to some £17½ million) from the Swiss Federal Government to H.M. Government. This agreement, which came into force at the end of 1961, provides that the loan shall bear interest at 3% per annum and be repayable not later than the 31st December 1964, although the United Kingdom has the right to repay earlier subject to consultation with the Swiss authorities. This loan is comparable with the U.K. drawing on the I.M.F., no part of which was in Swiss francs as Switzerland is not a member of the I.M.F. The loan has been used to repay the final £17½ million outstanding under the Basle arrangements and owed to Switzerland.

[a] The effects of the Basle transactions on holdings of marketable government debt and balance of payments figures are explained on page 14.

I.M.F. repayment

With the Basle debts effectively repaid it was decided in October to take the opportunity provided by the large increase in the reserves during that month to make an early repayment in U.S. dollars of £100 million of the drawing from the I.M.F. A further £50 million was repaid at the end of November. These repayments automatically increased by an equal amount the facilities available under the standby agreement. These facilities, which expire in August 1962, total U.S. $920 million and can be drawn upon immediately if required.

Domestic situation

By the end of October it had become clear that the July measures were affecting consumers' expenditure. After a peak reached in July, itself partly due to anticipatory buying, the trend in sales of consumer goods had fallen. Sales of cars and household durable goods were markedly reduced, being affected by the imposition of a 10% surcharge on purchase tax and the other main Customs and Excise duties and by the restriction of consumer credit, including perhaps, in the case of cars, the raising by the Finance Houses Association of maximum charges and minimum down-payments. The increases in total fixed investment expenditure and in the public sector's current purchases of goods and services were probably still continuing in the third quarter. Manufacturers' investment in stocks seemed little changed though that of retailers had fallen. Making allowance for seasonal factors, industrial production appeared to have remained steady in July and August, at a rate some 1% higher than in the period April—June; the rise was mainly attributable to a growth in the output of the engineering and building industries. There was a distinct easing in the labour situation. On the whole the pressure of home demand appeared for the moment to have weakened slightly though home demand for plant and machinery remained high. The trend in exports continued to be nearly flat, but new overseas orders for plant and machinery seemed to be rising.

After a rise in August, following the imposition of the surcharge in July, retail prices remained broadly steady in September. There was some tendency for the upward drift in labour costs to continue, owing to the implementation of wage awards agreed before the 25th July and to increases for workers whose incomes are linked by sliding scales to price indexes.

The results of a Board of Trade survey published in September, but almost completed before the announcement of the July measures, reinforced the earlier belief that the growth in private industrial investment would slacken during 1962. Replies to the survey suggested that there would be a fall in investment by manufacturing industry though there would be a further increase in investment in distribution and other services. Some decrease in private and local authority house building might have occurred independently of the July measures which might therefore have accentuated an existing trend. In October it seemed that while local authority expenditure on housing might fall, public investment as a whole would certainly rise. It was officially estimated[a] that public investment would increase in the financial year 1962/63 by 5%, at constant prices, above its expected level for 1961/62.

At the same time the continued restrictions on credit and the pause in increases in wages, salaries and dividends made it likely that there would be no more than a moderate rise in consumers' expenditure over the next few months. The prospective easing of demand in some sectors, the weakness of raw material prices, the restriction of credit and the high level of short-term interest rates suggested that the rate of stock accumulation would continue to moderate. On the other hand the rise in public authorities' current expenditure was expected to continue.

Although in October there was little sign of the hoped for recovery in exports, with rising world demand the prospect was that they should begin to rise. Imports were also expected to rise, but more slowly than exports.

The general prospect as it appeared in October was, therefore, that the intense pressures foreseen in the early summer would be avoided provided the restraint of credit and the avoidance of increases in money incomes

[a] " Public Investment in Great Britain October 1961 " (Cmnd. 1522).

in excess of increases in productivity were continued.

During the summer and early autumn there seemed also to have been a distinct change in the climate of business opinion. Reports suggested that the July measures, the United Kingdom's application to join the European Economic Community and a continued narrowing of profit margins had led to a reappraisal of prospects and a greater concern over the need for British industry to pay closer attention to its competitive position.

The banks

In July the banks had been told that it was the wish of the authorities that the impact of the further call for Special Deposits should fall primarily on advances and particularly on those associated with the financing of consumers' expenditure and property development. In addition they were asked to discourage the growing tendency for recourse to bill finance as an alternative source of credit.

The trend of bank advances which had been upwards since the middle of 1958 changed abruptly after July. In the three months ended mid-October advances by the London Clearing Banks, excluding those to the nationalised industries, fell by £292 million. Seasonal factors may have accounted for some £100 million of this. In addition, in October, after discussions with the Bank about new and improved banking statistics, the clearing banks and Scottish banks standardised their accounting treatment of balances held with banks abroad and of certain other items. The reclassification of these items had the effect of reducing advances of the clearing banks by about £40 million and of increasing " Money at Call and Short Notice " by a similar amount. Allowing for both these factors the underlying fall in their advances amounted to some £150 million, most of which occurred during the two months to mid-September.

The fall was not merely the result of the July measures. For some months before July the liquidity ratios of the clearing banks had been under pressure so that increases in advances had to be financed largely by sales of investments. By mid-July the ratio of advances to gross deposits was over 47%, the highest level since June 1932, whereas investments represented only 14% of gross deposits. During the first half of 1961 many of the banks had taken steps to reduce the rate of increase in their advances. This was not easily or quickly achieved, for demand was very strong and was perhaps increased by " leads and lags "[(a)] arising from suspicions of sterling which had been current between March and July. Moreover, although balance sheet pressures were a matter of real concern, they were not so intense as to force the banks to halt abruptly, still less reverse, the rise in advances.

The repayment of advances by domestic borrowers seems to have been financed in part by the reversal of the adverse leads and lags position, the continuing high level of new issues, and falls in the stocks of those who were financing stocks through bank advances; in addition there were repayments by overseas, especially sterling area, borrowers as a result probably of both pressure from the banks and the high level of U.K. interest rates.

The amount of money raised through new issues had risen sharply over the past two years, but in the third quarter reports suggested that an increasing proportion was being raised primarily to pay off existing bank advances. In addition any investment inflow of funds to the United Kingdom, or switching of foreign currency deposits into sterling, which put funds at the disposal of local authorities and hire purchase finance companies, would have provided means for these borrowers to repay bank advances.

It is unlikely that there would have been time for reductions in many existing advances to be both negotiated and carried out between the end of July and the middle of September which was, in any case, a holiday period. Part of the fall in advances was therefore probably due to repayments already negotiated. There may also have been a big fall in demand for

(a) In the circumstances then ruling, foreign importers of U.K. goods would tend to delay payments to U.K. exporters who would therefore be forced to provide additional credit, some part of which might be financed through increases in bank advances. At the same time, but it seems to a lesser extent, U.K. importers might hasten payments due to overseas exporters which again might lead to increased use of bank advances. Alternatively, changes in the timing of payments could affect the level of bank deposits in the United Kingdom.

new advances brought about by the change in the immediate economic prospect, as well as by the known stricter attitude of the banks, coupled with the exceptionally high level of overdraft rates.

The advances of the Scottish banks, excluding those to the nationalised industries, fell by £32 million between mid-July and mid-October, or some £20 million if allowance is made for the usual seasonal fall. Proportionately, the underlying fall since the middle of July was similar to that of the clearing banks.

During the third calendar quarter the overseas and foreign banks and the accepting houses together reduced their advances to U.K. residents by £12 million. This includes advances denominated both in sterling and in foreign currencies; but other available information showed that the British overseas banks, the accepting houses and the " Other Foreign Banks " all reduced their sterling advances to U.K. residents. During the same period the American banks greatly reduced the rate of increase in their sterling advances to U.K. residents and in October these advances fell sharply to below their total at the end of July.

The banking sector also reduced its holdings of commercial bills during the late summer. The combined holdings of the clearing banks, Scottish banks and discount houses fell by £45 million between mid-August and mid-October. Commercial bill holdings of the overseas and foreign banks and the accepting houses are not available monthly, but over the third calendar quarter they rose by £17 million. Over this quarter acceptances outstanding on behalf of U.K. residents were little changed in the case of the overseas and foreign banks, but those of the accepting houses rose by £11 million.

At the end of October it seemed that advances might continue to fall until the New Year, but were likely to rise after that under the pressure of the normal heavy revenue payments to be expected during the first calendar quarter. The demand for advances may be especially strong from companies, many of which are already less liquid than usual owing to recent pressures on profit margins.

The fall in the clearing banks' advances was accompanied by a similar, though less abrupt, downturn in net deposits. These fell during the three months ended mid-October by £68 million, whereas on seasonal grounds alone a rise of about the same amount might have been expected. This fall was in part the result of the reduction in advances and the resumption of net official sales of stock in the gilt-edged market. These influences were to some extent offset by the seasonal Exchequer deficit and the reversal of the leads and lags position in so far as the latter led to a rise in deposits. If allowance is made for seasonal factors, net deposits rose steeply from January until mid-April, ran about level for two months and then turned downwards. The pressures of credit restraint made it likely that the trend of net deposits would continue downwards.

Owing to the fall in advances, the liquidity position of the clearing banks became easier, in spite of the increase of £71 million in Special Deposits between mid-July and mid-October. Investments were virtually unchanged during the two months ended mid-September, but in the following month the banks bought £50 million of gilt-edged stocks, the largest monthly increase since October 1953. It may be that the banks were the more ready to buy gilt-edged stocks in so far as they could see their way to advance reinvestment of their holdings of $4\frac{1}{2}\%$ Conversion Stock 1962, which matures in February; they may also have been influenced by the increase in their liquid assets resulting from the reclassification of assets referred to previously.

The gilt-edged market

The prices of gilt-edged stocks fell sharply on the announcement of the July measures. They fell further on the enactment of the Trustee Investments Bill on the 3rd August, but the initial volume of switching by trustees from gilt-edged stocks to equities was less, in fact, than some had expected. In early August yields on medium and long-dated stocks were around $6\frac{3}{4}\%$ and on $2\frac{1}{2}\%$ Consolidated Stock around $6\frac{7}{8}\%$. Prices then began to rise partly because of the attraction of these yields and partly because the discount market became a net purchaser of bonds, so reversing its sales during the period before July. The rise in prices did not persist for long and yields were virtually unchanged between the middle of August and the end of September. During these months the authorities bought in $4\frac{1}{2}\%$

Conversion Stock 1962 chiefly against sales of other short-dated stocks and, on balance, they were net sellers.

The reduction in Bank Rate from 7% to 6½% on the 5th October added strength to a renewed rise in gilt-edged prices. The clearing banks had entered the market as buyers and there were reports that overseas money was again being invested in gilt-edged stocks. The market also benefited from uncertainty in the equity market brought about by repeated warnings of difficult trading conditions and lower profits, the Chancellor's request for dividend restraint and by heavy calls on account of new issues. Net official sales increased considerably early in October though not to an extent that prevented prices rising, particularly among the short and medium-dated stocks. During October yields on these stocks dropped by over ½% and those on long and undated stocks by about ¼%. There was a further fall in yields after the ½% reduction in Bank Rate on the 2nd November.

The reductions in Bank Rate By the end of September the short-term objectives which the authorities had had in mind in raising Bank Rate to 7% in July had largely been achieved. The outflow of funds from London had been halted and the immediate dangers to sterling had been overcome; and the July measures were beginning to take effect in the domestic field.

The authorities had at this time to consider how large an inflow of foreign money to expect as a natural reversal of the earlier outflow. There is no 'normal' level of overseas non-official holdings of sterling. Moreover, any concept of 'normality' presupposes a 'normal' relationship, equally imaginary, between the level of interest rates in the United Kingdom and other countries. At almost any point of time reasons can be found for maintaining that the position is exceptional. Nevertheless, in recent years, sharp falls in non-official sterling holdings of countries outside the sterling area, at times when there have been doubts about sterling, have largely been made good when confidence has been restored. This is, for instance, obviously true of 1957-58.

Over the first nine months of 1961 non-official holdings of sterling by countries outside the sterling area fell by some £470 million. Allowing for the effects of the Basle arrangements, this fall had occurred by July and there was little change between then and the end of September, when these holdings totalled £440 million. At this level they were approximately equal to their level at the end of 1958 when non-resident convertibility was re-introduced. Since 1958, sterling has gradually become more widely used by non-residents and some underlying increase in non-official holdings must be judged to have occurred, even though these holdings may have been abnormally high at the end of 1960. In September, the immediate threat to confidence had passed and it was therefore to be expected that, given the level of interest rates ruling in the main financial centres, the very high short-term rates in London would cause investment funds to return to the United Kingdom. But there was nothing to be said for too large and rapid an inflow of short-term capital. On the other hand, the domestic credit situation did not justify a marked reduction in short-term rates, even if it did not require the maintenance of rates at the very high levels established in July.

In these circumstances it was decided as an initial move to reduce Bank Rate from 7% to 6½% on the 5th October. This reduction came sooner and was smaller than many had expected. It was followed by a considerable inflow of investment funds and short-term rates fell. On the 2nd November Bank Rate was reduced by a further ½% to 6%. Incidental advantages of these reductions were a welcome lowering of the external cost of interest on overseas sterling holdings and a reduction in the cost of export credit.

Economic conditions abroad The prospective slackening in the pressure of domestic demand indicated by the preceding review of the domestic situation should increase the supply of goods available for export. Whether or not exports in fact increase will depend not only upon their availability, competitiveness and the state of demand abroad, but also to a large extent on the aggressiveness of U.K. salesmanship.

During the third quarter of 1961 the pace of recovery in the United States slackened a little. Industrial production rose less rapidly in July and August than in the preceding months; and gross national product, after rising by 3% between the first and second quarters of the year, rose by just under 2% in the third quarter. Government expenditure and private investment, including stockbuilding, appear to have been the most important forces behind this expansion of activity. In October it seemed likely that these forces of expansion would persist in 1962; government expenditure might not be so strong a force, but the rise in private investment might accelerate. On the other hand personal consumption had not risen as fast as might have been expected in view of the substantial rise in personal incomes, though retail sales increased markedly in October. The extent of a further rise in output over the coming year would depend to an important degree on the behaviour of consumer demand.

In continental Western Europe the growth in industrial production slackened in the second quarter of 1961 and seemed to have continued to do so in the third. This development appeared to be due rather more to physical limitations than to a slackening of investment demand. In Western Germany and the Netherlands there was little spare capacity and shortages of labour were acute. In Italy also there were reports of shortages of skilled industrial labour. The main exception was France where output continued to grow without apparent strain on resources.

Fixed investment continued to be an important element in the growth of total demand in these countries, although by the end of the period there was some sign of its slackening, notably in Western Germany. In addition personal consumption was stimulated in many countries by the growth of employment and increases in wage rates. This trend seemed likely to continue. In a few countries[a] the authorities had taken action to keep the rise in demand within the limits of available resources. In general it seemed likely that demand in Western Europe would continue to expand in the months ahead and that output was likely to continue to grow, although not so fast as in 1960.

In some West European countries earnings rose faster than productivity with a consequent rise in prices. If this tendency persisted it might significantly affect these countries' competitive position in world trade. On the other hand a marked slackening of home demand in Western Europe, which might result from further restrictive measures or from a slower growth of investment, could be expected to intensify competition in world markets.

In the first half of 1961 the imports of many primary producing countries had declined following measures taken to overcome balance of payments difficulties experienced in the second half of 1960. In addition, in some of these countries exports had improved as the decline in many commodity prices ceased. By the third quarter the volume of imports into primary producing countries seemed to be running level, but the volume of their exports seemed in general to be rising. There was a renewed fall in some commodity prices, which might largely offset the improvement that might otherwise be obtained from an increase in the volume of their exports.

The trend in the balance of payments of the overseas sterling area continued to improve during the third quarter; in particular, the improved trading position of Australia was maintained. In addition the imposition of controls alleviated the strains on South Africa's reserves that had arisen from the outflow of capital. Other sterling area countries, notably Ghana, India, New Zealand and Nigeria, continued to experience balance of payments difficulties and some of them took further steps to curb their imports.

In October therefore it seemed probable that, in general, demand abroad would rise, though perhaps slowly, in the immediate future. Conditions in many West European countries suggested that their demand for imports should be strong, but could be affected by a reduction in the rate of stockbuilding. The prospects were that U.K. exports to sterling area countries would at least be maintained. Much, however, depended upon the course of economic activity in the United States, for the extent of any increase in U.K. exports to the U.S. market would be considerably affected by

[a] In particular Denmark, the Netherlands, Norway and Sweden.

the rapidity with which consumers' expenditure there might expand.

Balance of payments The U.K. balance of payments on current and long-term capital account was unchanged in the third quarter. A small rise in the deficit on current account was matched by a reduction in the net outflow of long-term capital. This rise in the deficit on current account was less than might have been expected, after taking into account the usual seasonal deterioration in the balance of both visible and invisible transactions. The trend of imports continued downwards. Imports of basic materials were lower, perhaps partly because of a further reduction in the rate of stockbuilding in certain industries, itself partly attributable to the July measures, and there was a pause in the rise in imports of machinery which had persisted for two years. This was unexpected in view of the continuing rise in industrial investment and seemed unlikely to persist over the near future. The trend of exports seemed to be rising slightly, partly because they again included several deliveries of ships. Excluding ships, exports to overseas sterling area countries continued to fall, whereas sales to the United States improved and those to Western Europe continued to grow at a satisfactory pace.

The reduction in the net outflow of long-term capital took place even though special receipts fell: in the second quarter £45 million was received from Western Germany as an advance repayment of debt; in the third quarter France repaid in advance a £27 million E.P.U. debt.

The "Balancing item" was again positive in the third quarter and considerably larger than in the second. In the first nine months of 1961 there was a positive "Balancing item" amounting to £222 million even though there was almost certainly some unrecorded outflow of funds in the second quarter. By definition the contents of the "Balancing item" can only be surmised, but its recent performance strengthens an inference from earlier figures that the size of recent deficits, as recorded in identified current and long-term capital transactions, may perhaps have been somewhat over-estimated.[a]

The prospect that the pressure of home demand on resources will diminish for the time being and the probability of increased demand abroad, both suggest that a further improvement in the trade balance is within reach. The United Kingdom has made a claim for assistance in meeting the cost of forces in Western Europe, the outcome of which should be to reduce government expenditure overseas. It can be expected that overseas long-term investment in the United Kingdom will be maintained. Compared with the position as seen in the early summer of 1961, the outlook for most of 1962 is therefore much improved. Later developments will depend on the success of longer-term policies and in particular upon the growth of exports.

The more favourable immediate outlook for the balance of payments is partly due to developments which must be expected to be largely temporary. The short-term measures adopted in July will limit the growth of imports in 1962 by restraining the rise in domestic demand including stockbuilding. But if growth of the economy is maintained, and even more if it is accelerated, imports must be on a rising trend. The expected increase in exports in 1962 partly depends upon supplies of plant and machinery becoming available for export as a result of a somewhat lower rate of investment by British manufacturing industry. But a sustained growth of exports is unlikely if the decline in investment lasts for long, particularly if the investment plans of the capital goods industries are affected. Present commitments and policies on aid and defence suggest that in the long run government external expenditure will tend to rise. An article on page 17 of this Bulletin suggests that there is, in present circumstances, little prospect of a significant improvement in other current invisible transactions. If the United Kingdom were to become a member of the European Economic Community, opportunities for U.K. exports to the other members of the Community would improve; but so would the opportunities for European sales in the British home market.

---

[a] The estimate of the desirable rate of growth in U.K. exports published in the previous Bulletin assumed that some positive "Balancing item" would continue.

These underlying trends in the balance of payments may be hidden for a while by an immediate improvement resulting from the short-term measures recently adopted. If this occurs there might be a risk that the vigorous pursuit of longer-term policies, designed to secure increased efficiency and flexibility of the economy, will be relaxed. But the success of these policies is essential if the United Kingdom is to achieve the growth of exports on which lasting external solvency and the future expansion of the economy still rest.

QUARTERLY ANALYSIS OF BANKING AND EXCHEQUER STATISTICS

22nd June—20th September 1961

Banking As a more than usually detailed discussion of banking figures has been included in the main part of the Commentary (see page 7), the discussion in this section is confined to the classification of bank advances at mid-August.

Between mid-May and mid-August advances by all members of the British Bankers' Association increased by only £16 million (excluding advances to the nationalised industries). This was much the smallest increase for any comparable quarter since 1957. The quarter included two months in which advances were rising and one in which they were falling; so the detailed classification is not wholly reliable as a guide to which categories of borrowers have reduced their advances most since July. Between mid-May and mid-August there was probably some net increase in advances to industrial borrowers (seasonal factors apart). There was little change, in total, in advances to the three groups associated with consumer financing: hire purchase finance companies, retail trade and personal and professional. Advances to hire purchase finance companies alone rose by £12 million, but the steps since taken by the clearing banks to reduce such advances make it likely that they have subsequently fallen.* Advances classified as "Other Financial" again rose, by £13 million.

Exchequer statistics During the period 16th March—20th September, the overall budget deficit amounted to £599 million, much the same as a year before. The 1961/62 budget figures may not begin to diverge from those for 1960/61 until the main revenue quarter ending in March 1962, when the overall budget surplus may be larger than that realised in the comparable quarter of 1960/61.

During the quarter ended in mid-September the overall budget deficit was £381 million, while internal extra-budgetary funds brought in £75 million (the same as a year before). However, external items yielded £230 million so that the Exchequer's cash requirement came to only £76 million. The U.K. drawing from the International Monetary Fund had no overall effect on the Exchequer's cash position, for the sterling, amounting to £536 million, paid to the I.M.F. by the Exchange Equalisation Account in exchange for foreign currencies was lent back to the Exchequer against non-interest-bearing notes and showed as a receipt under the heading of "Other External Items (net)".[a] These transactions apart, the E.E.A. sold foreign currencies and so acquired sterling to the extent of £217 million, largely in consequence of the net repayment of Basle support totalling £152½ million, while other external items brought in £13 million net, more than accounted for by an advance repayment of £27 million E.P.U. debt by France.

There was a net fall of £66 million in government debt and Bank of England notes held, directly or indirectly,[b] outside the banking system.[c] This reduction, together with the Exchequer's cash requirement of £76

---

[a] See Table 1 of the Statistical Annex.

[b] Changes in the discount market's holdings of government debt are treated as changes in the "indirect holdings" of those from whom the market has borrowed (net).

[c] "Banking system" means only the London Clearing Banks, the Scottish banks and the Banking Department of the Bank of England, the appropriate figures for other banks not being available for the same quarterly dates.

* The classification for the period ended mid-November, which became available after this Commentary was written, shows that advances to hire purchase finance companies by all members of the British Bankers' Association fell by £42 million over the previous three months.

million, was met by borrowing £142 million from the banking system:

ESTIMATED CHANGE IN HOLDINGS OF GOVERNMENT DEBT AND BANK OF ENGLAND NOTES BY THE BANKING SYSTEM[(a)]

22nd JUNE - 20th SEPTEMBER 1961

£ millions

Bank of England, Banking Department:		
Direct holdings ...	+ 52	
Indirect holdings ...	+ 4	+ 56
Clearing banks and Scottish banks:		
Treasury Bills	+110	
Stocks	− 40	
Indirect holdings ...	+ 15	+ 85
Bank of England Notes[(b)]		+ 1
		+142

The increase in direct holdings by the Banking Department was due to Special Deposits received from the clearing banks and Scottish banks. The increase was less than that in Special Deposits (£79 million), largely because of a fall in the clearing banks' ordinary deposits with the Bank of England. The clearing banks and Scottish banks acquired £86 million of government debt, Bank of England notes and coin. £79 million was acquired by the clearing banks, but this was not accompanied by the rise in net deposits usual at this time of year; instead there was a moderate fall, referred to on page 8, which was associated with a much sharper decrease than usual in advances to the private sector.

The next table analyses the net reduction of £66 million in government debt and Bank of England notes held outside the banking system:

ESTIMATED CHANGE IN HOLDINGS OF GOVERNMENT DEBT AND BANK OF ENGLAND NOTES BY HOLDERS OTHER THAN THE EXCHEQUER GROUP[(c)] AND THE BANKING SYSTEM[(d)]

22nd JUNE - 20th SEPTEMBER 1961

£ millions

Government debt		
Overseas official holders:		
Treasury Bills ...	−64	
Stocks	−42	−106
Other home and overseas non-official holders:		
National Savings ...	− 9	
Tax Reserve Certificates	+51	
Treasury Bills ...	+15	
Stocks	+11	
Indirect holdings[(e)] ...	−23	+ 45
Bank of England Notes ...		− 5
		− 66

For the first time for four years National Savings failed to contribute to the quarterly financing of the Exchequer; there was a net repayment of £9 million compared with net receipts of over £50 million both in the previous quarter and in the third quarter of 1960. In the preceding quarter the unfavourable comparison with 1960 had been largely due to lower net receipts from National Savings Certificates; this time there was also a sharp drop in net receipts from Defence Bonds. The yields on both these securities, which in the case of Defence Bonds had been unchanged since the first issue of 5% Bonds in 1958, and in the case of National Savings Certificates since August 1956, were often less than could be obtained from some other securities, including some gilt-edged stocks of comparable maturity and deposits with hire purchase finance companies. Subscriptions to Tax Reserve Certificates were again less than in

(a) This table is derived from Table 2 of the Statistical Annex.

(b) Including some coin.

(c) The Exchequer, the Paymaster General, the National Debt Commissioners, the Exchange Equalisation Account and the Issue Department of the Bank of England.

(d) This table is derived from Tables 1 and 2 of the Statistical Annex.

(e) Including some overseas official.

the corresponding quarter of 1960. They fell away sharply after the July measures because a rise in the interest rate was expected; after the rate had been raised from 3% to 3½% (tax free) on the 12th August there was a marked improvement.

Overseas funds Marketable government debt held by " Overseas official " holders fell by £106 million, but net repayments of Treasury Bills taken up under the Basle arrangements totalled £118 million, so that there was little other net change. " Other home and overseas non-official " holdings of marketable government debt, direct and indirect, were practically unchanged in total, but there was a rise of £28 million if net repayments of Basle money are excluded.

It is, as usual, difficult to estimate the " overseas " element in the net take-up of marketable government debt by " Other home and overseas non-official " holders. It is clear that there was an outflow of private short-term funds in the early part of the period followed by some reflux after the 25th July, but it is not easy to assess the amounts involved. In the calendar quarter, July—September, there was no net change in total reported non-official overseas sterling holdings beyond that due to repayments of Basle money. The balance of payments estimates indicate a " Balancing item " large enough to imply the possibility of considerable unrecorded net receipts from abroad either in the form of a reversal of short positions or of an inflow of funds for investment. In the calendar quarter there may have been some net inflow of private short-term capital,[a] but the ' banking quarter ' ended the 20th September includes the last part of June, when an outflow of funds was occurring, and excludes the last part of September when some inflow might have been occurring. In the ' banking quarter ', therefore, there was probably no net inflow of funds for investment. It is probably true of both " other home " and " overseas non-official " holders that they were selling marketable government debt before mid-July and buying between then and mid-September but that in each case the net change over the whole three months was not very great. Certainly the authorities became net sellers of gilt-edged stocks in August and September whereas they had been net buyers in July.

Basle arrangements Assistance outstanding under the Basle arrangements again affected published statistical series. On the 20th September £64½ million of assistance was outstanding of which £49½ million was included in " Overseas official " holdings of marketable government debt and £15 million in " Other home and overseas non-official " holdings. On the 30th September £10 million of the assistance then outstanding was included in official overseas sterling holdings and the remaining £17½ million in " Miscellaneous capital (net) ".

Private sector It was suggested in the September Bulletin that, after allowance for seasonal factors, the financial surplus of persons in the second quarter of 1961 might, compared with the first quarter, have fallen slightly and that of companies have risen a little. National income estimates now suggest that consumers' expenditure did not rise in line with the large increase in personal incomes, and that personal savings in the second quarter may have exceeded £700 million (compared with £500 million a year before). It therefore appears that the financial surplus of persons, seasonal factors apart, rose between the first and second quarters, but that of companies was little altered. These changes do not affect the probability that, in view of a reduction in the budget deficit, there will be a fall in the financial surplus (seasonally adjusted) of the whole private sector in the second half of this financial year as compared with the first, but this is not likely to be confirmed until the revenue quarter. The evidence available in October suggested that no large change took place in the quarter ended September 1961.

There were some notable changes in the disposition of the private sector's financial surplus in the third quarter, compared with the third quarter of 1960. Because of the large fall in bank advances, only partly offset by a fall in deposits, there was a net

[a] Particularly in the form of a reversal of short positions.

decrease of some £130 million in the finance made available to the private sector by the banking system as a whole compared with an increase of £25 million in the corresponding quarter of last year. Net private long-term investment overseas was probably greater than a year before. Thus with more of the private sector's financial surplus absorbed by net repayments to the banking system and by net lending abroad, less was lent to the Government than a year earlier. It was estimated above that the private sector probably took up little marketable government debt in this period, and there was some net withdrawal of funds from National Savings. At the same time net subscriptions to Tax Reserve Certificates were lower.

Within the private sector, the main identifiable feature in the financial transactions of persons was a marked decline in subscriptions to National Savings, a net repayment of £9 million in contrast to net subscriptions of £52 million in the same quarter of 1960. There may well have been a sizeable reduction in bank advances to persons, though this is uncertain because through the accident of timing this did not show in the quarterly analysis of bank advances over the period from mid-May to mid-August, much of the heavy fall in total advances occurring after the latter date. During the quarter most building societies raised the rates of interest paid on shares and deposits by ¼% (income tax paid) in order to halt a fall in their net receipts. However, following the increase in Bank Rate at the end of July, there were some sharp rises in the interest rates offered by some competing forms of savings and net personal lending to the societies again fell slightly. Although in this quarter the societies drew a greater amount than in the previous quarter from the Exchequer under the scheme, now in suspense, for assisting the purchase of older houses, net advances by the societies declined. Personal saving through life, annuity and pension funds continued to absorb large amounts at a rate which probably exceeded £200 million a quarter.

The proceeds of new capital issues[a] by 'non-financial' companies continued to be higher than a year earlier and totalled £163 million in the third calendar quarter compared with £85 million. On the other hand the large fall in bank advances between mid-June and mid-September must be presumed to have affected these companies to a substantial extent. This may be partly explained by the reversal of short positions and a fall in the rate of stockbuilding but it seems fair to infer that 'non-financial' companies' liquid assets also came under increasing pressure. Some reduction in companies' bank deposits would be consistent with the trend of total deposits shown in the banking statistics; companies may also have sold marketable government debt.

Financial institutions (outside the banking system[b]) raised large amounts through capital issues; investment trusts were the main borrowers. Hire purchase finance companies did not raise any new capital; but members of the Finance Houses Association increased their deposits from the public by £29 million, a greater increase than in the previous quarter. Their deposits fell in July but after the rise in Bank Rate most finance houses raised the interest rates they offered and deposits rose in August and September. The increase in deposits was not used to finance any expansion in hire purchase business (indeed debt owing to finance houses scarcely changed during the quarter) but was most probably needed to fulfil existing commitments while outstanding bank advances were being reduced.

There were some marked changes in the third calendar quarter in the figures of the overseas and foreign banks in London and the accepting houses, which are not at present incorporated in the "banking system" for the purpose of this analysis. During the second quarter these groups of banks had reduced their short-term sterling assets, excluding balances with other U.K. banks, by about £95 million and had increased their advances to U.K. and overseas residents by some £140 million. In contrast, during the third quarter they increased their short-term sterling assets by some £65 million and reduced their advances by £40 million. This change was in line with the request made to them in

[a] A new series of figures for "Capital Issues on the United Kingdom Market" is given in Table 15 of the Statistical Annex and described in an article on page 35.

[b] See footnote [c] on page 12.

July to reduce substantially the previous rate of growth in their sterling advances in the United Kingdom; in the second quarter total advances to U.K. residents had risen by £51 million but in the third quarter they fell by £12 million. It was also an expected response to the high level of U.K. short-term interest rates and is consistent with some net switching of foreign currency deposits into sterling in contrast to the move in the opposite direction that seemed to have occurred in the second quarter.